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China's Monetary Policy Update: Stronger and More Targeted to Reinforce Recovery

By LI Yao

China's economy started with a better-than-expected performance in early 2022.[1] However, the negative impacts of intermittent COVID-19 lockdowns became apparent in March, and together with the unanticipated geopolitical events, formed mounting headwinds for the economy. After Premier Li Keqiang warned of a "grave and uncertain" outlook for the Chinese economy in his annual work report on 5 March 2022,[2] the Chinese government has announced and launched several waves of stimulus measures, including dozens of monetary policies.

Compared to the measures applied following the first wave of COVID-19 breakout in 2020 that aimed to provide strong stimulus to the economy, China's monetary policy in recent months indicate several changes: from an aggregate monetary easing to emphasising more on specific targets; from focusing heavily on bank's lending capability (debt side of banks' balance sheet) to being more supportive of borrowers (asset side of banks' balance sheet);[3] and

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[1] The year-on-year growth of China's gross domestic product (GDP) was 4.8% in the first quarter of 2022, higher than the 4% recorded in Q4 2021 and the 4.4% of forecast by Reuters poll of analysts. For more details, please see https://www.cnbc.com/2022/04/18/china-economy-q1-gdp-beats-expectations-to-grow-4point8percent-yoy.html and https://www.reuters.com/world/china/china-data-show-sharp-march-deterioration-covid-bites-solid-q1-growth-2022-04-17/, accessed 17 June 2022.

[2] For more details, please refer to https://www.reuters.com/markets/asia/china-cuts-2022-gdp-growth-target-around-55-2022-03-05/, accessed 20 June 2022.

[3] The results of expansionary monetary policy are the expansion of balance sheet for banks and further expansion of companies and households' balance sheets. This can be realised through either the debt side or the asset side of banks' balance sheets.

from passively smoothing the impact of fiscal policy on financial liquidity to actively supporting the implementation of fiscal policy with funds (more supportive to government).

Recent economic data has shown that the liquidity supply pressure on the debt side of financial institutions has improved significantly. To stimulate the current weak economy, monetary expansion cannot be achieved simply through an easing of aggregate credit similar to those in response to the COVID-19 pandemic in 2020. Evidence can be seen in at least four aspects:

a. First, the slowing growth of base money balance and lower market interest rate indicate sluggish market demand. The year-on-year growth rate of base money was 2.56% in April 2022, lower than that of the previous month (2.6%).[4] At the same time, the monthly averages of the seven-day pledged repurchase weighted average interest rates of interbank and depository institutions (R007 and DR007) in April 2022 were down about 0.4 and 0.3 percentage points from that of the previous month, respectively.[5] Their spreads with the seven-day OMO (open market operations) operating policy rates increased to -0.15 and -0.28, historically second only to that of April 2015. Therefore, both the balance of base money and market interest rates are moving down, with market interest rate lower than policy interest rate, indicating sluggish market demand for base money.

b. Second, the mechanism of money creation has been blocked, further undermining the effectiveness of the credit ease policy. As the prospects of both enterprises' profits and residents' employment income are uncertain, investment and consumption are both weak, which further dampen the demand for credit. In April 2022, M2[6] increased by 10.5% year-on-year, higher than that of the first three months (a respective 9.8%, 9.2% and 9.7% for January, February and March), albeit at a marginal increase of RMB202.3 billion month-on-month, which was significantly lower than the average month-on-month increase of RMB3.8 trillion in the first quarter. In terms of money creation channels, the reductions in bank credit (expanded by RMB0.39 trillion, down from the RMB3.4 trillion in March) and net fiscal expenditure (up by RMB0.51 trillion, but still down from the RMB0.95 trillion in March) are the top two main reasons for the slowing down of M2 growth.[7] To stimulate credit demand, the People's Bank of China (PBoC) has lowered the LPR (loan prime rates) in May 2022 and the State Council executive meeting has launched 33 "measures".[8] However, the effectiveness of the policies is not optimistic.

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4 The month-on-month change of base money balance in the same month is negative 2.57% (the balance decreased by RMB863.5 billion from that of the previous month); the decline exceeded that of the same period in the past three years.

5 The R007 and DR007 in April 2022 were 1.95% and 1.82% respectively.

6 M2 for China is a measure of money supply including all physical currency circulating in the economy (banknotes and coins), operational deposits in central bank, money in current accounts, saving accounts, money market deposits and small certificates of deposit.

7 The central bank's foreign exchange holdings decreased by RMB17.63 billion (an increase of RMB23.24 billion in March) and the decrease of asset management products purchased by banks due to maturity retrieved another RMB0.76 trillion of credit from the market (an increase of RMB1.4 trillion in March) also contributed to the decline in market credit growth.

8 For more details, please refer to http://english.www.gov.cn/policies/latestreleases/202205/31/content_WS6295ca6ec6d02e533532b89b.html, accessed 13 June 2022.

c. Third, the risk of funds and liquidity idling in the financial system is increasing. While policies have eased the credit, the demand for credit is weak. The year-on-year growth rates of loans had decreased by 0.19%, 0.31% and 0.76% in April 2022 for the four state-owned banks, large national banks and small and medium-sized banks respectively. However, the bill financing of the four state-owned banks and national large banks increased by a respective 118.9% and 77.3% year-on-year for the same month. These were about 35 and 23 percentage points higher than that of March, suggesting a significant acceleration. Meanwhile, the growth rate of bill financing for small and medium-sized banks fell by 1.37%, implying that the pressure of the "easy credit" policy is mainly concentrated on the four state-owned banks and large national banks. Due to the economic slowdown caused by the epidemic and the support of macro policies, the funding shortage of enterprises is no longer urgent. As a result, China's large national banks have recorded the first decline of short-term loan since August 2021 and the growth of short-term loans has also significantly softened for the four state-owned banks. In terms of medium and long-term loans, the growth rate of loans from the three types of banks has continued to decline, with that of the four state-owned banks most significantly impacted. Therefore, the four state-owned banks and the large national banks have to expand bill financing to fulfil credit ease tasks, a byproduct of the increasing risk of funds and liquidity idling in the financial system.

d. Fourth, the demand for interbank financing is also weakening. The balance sheet of other depository corporations shows a slight increase in the liabilities (borrowing) of other depository corporations. Both the year-on-year and month-on-month growth rates in April 2022 were significantly smaller than those in March, indicating that the market has abundant funds and the demand for interbank financing is not as active as in the previous period.

As aggregate expansion policies are not so effective in easing credit, the PBoC has since April 2022 focused more on lowering financing cost and tended to use the market-based adjustment mechanism of deposit interest rates to guide loan interest rates. In terms of quantity, the central bank clearly stated that "current liquidity is at a reasonable and sufficient level" when it cut the reserve ratio in April 2022. This also suggests that, in the next step, monetary policy may shift from aggregate policy to structural policy.

In April 2022, the PBoC had retrieved nearly RMB1 trillion of liquidity from the market, and the feature of "retracting short and releasing long" has become more obvious. Compared with the previous month, the net withdrawal of short-term liquidity instruments from the central bank increased by 60% in April, of which the net withdrawal of reverse repurchase instruments was RMB640 billion and the net release of MLF (medium-term lending facility) was nil. On the other hand, RMB530 billion long-term funds were released in a comprehensive Required Reserve Ratio (RRR) cut. The central bank is also expected to accelerate the implementation of existing structural policies, increase targeted credit expansion for small and medium-sized enterprises, low-carbon, agriculture-related, technological innovation and so on.

At the same time, due to the ease of short-term liquidity, total money supply has rebounded significantly and the debt side (funding source) of financial institutions' balance sheets has been significantly improved. China's monetary policy is now shifting from working on the debt side to focus more on the asset side of financial institutions' balance sheets and providing more support to borrowers. Debt side policies target at providing liquidity for financial institutions and reducing the debt pressure of financial institutions. On the other hand, asset side policies aim to activate demand of borrowers and help the asset expansion of financial institutions in

specific fields. In May 2022, the PBoC cut the lower limit of first home loan interest rate and the five-year LPR, which are all reflections of this policy idea.

In terms of the relationship with fiscal policy under severe economic downward pressure, China's monetary policy has shifted from passively smoothing the impact of fiscal policy on financial market liquidity to actively providing funds to support the implementation of fiscal policy.

The central bank gave a more detailed explanation of the support of fiscal expenditures for Value Added Tax (VAT) rebate refund through the handover of profit balances at the press conference jointly held with the Ministry of Finance and State Administration of Taxation on 10 May 2022.[9] To help speed up the VAT rebate refund process and implementation of fiscal expansion policies, the PBoC will turn over profits of over RMB1.1 trillion to the central government. As of 10 May 2022, it had turned over RMB800 billion. This is equivalent to a 0.4 percentage point reduction in RRR in terms of liquidity injection, which is expected to increase the growth of broad money (M2) supply for the year by about 0.5 percentage point.

Compared to the passive support of past monetary policy, PBoC's active support of the fiscal policy has at least two advantages. First, the RRR cut relies on the money creation system to realise money expansion while these funds from the profits handed over by the central bank will go directly to market players through tax rebates and increase their income. As the mechanism of money creation does not work smoothly in China now, the central bank's profits have directly increased the income of market entities, thus enabling them to carry out economic activities through fiscal expenditure and increase effective demand more than reducing the RRR. Second, issuing government bonds or special bonds and implementing fiscal expenditures by means of deficit expansion often squeeze out the liquidity of the private sector. The passive support of past monetary policy can only smooth the liquidity shock caused by the issuance of government bonds, tax payments and fiscal expenditures to the financial market. The central bank's boost to fiscal expenditure by turning over profits is equivalent to the direct release of base currency. This process will not crowd out liquidity from the private sector and instead, bring incremental supplement to the liquidity of the financial market.

However, the follow-up fiscal policies obviously need more fund support as the central bank's turning over of profits will be completed soon. The risk of market liquidity crunch is still high for China in the near future. There is therefore a need to implement follow-up monetary policy to increase money supply to support the expansion of credit demand. In addition, after the accelerated implementation of existing fiscal and monetary policies in June, more incremental fiscal and monetary policies are likely to be launched if the data in the second quarter shows below expected economic performance.

LI Yao is Research Fellow, East Asian Institute, National University of Singapore.

[9] http://www.mof.gov.cn/zhengwuxinxi/caizhengxinwen/202205/t20220510_3809339.htm, accessed 20 June 2022.

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